This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 03 PRETORIA 004879

SIPDIS

SENSITIVE BUT UNCLASSIFIED

DEPT FOR AF/S/JDIFFILY; AF/EPS; EB/IFD/OMA
USDOC FOR 4510/ITA/MAC/AME/OA/DIEMOND
TREASURY FOR OAISA/BARBER/WALKER/JEWELL
USTR FOR COLEMAN
LONDON FOR GURNEY; PARIS FOR NEARY

E.O. 12958: N/A
TAGS: ECON EINV EFIN ETRD SF
SUBJECT: MID TERM BUDGET POLICY STATEMENT

SUMMARY

¶1. (U) Finance Minister Trevor Manuel presented the Mid Term Budget Policy Statement (MTBPS), supporting the South African government's three-year budgeting plans under the Mid Term Expenditure Framework. The MTBPS updates economic growth, revenue and expenditure forecasts and suggests potential policy changes that support government's key priorities. Highlights of Manuel's presentation include: (1) fiscal policies remaining slightly expansionary with an increased budget deficit expected in the next fiscal year; (2) no substantial tax changes; (3) an additional R50 billion ($8 billion using 6.2 rands per dollar) aimed at poverty alleviation, infrastructure, and increased wages for teachers and police; and (4) relaxation of foreign exchange controls on South African corporations. Compared to last February's formal budget submission to Parliament, the SAG is now forecasting higher growth for 2005 and 2006. While macroeconomic indicators are good, the government still faces challenges in reducing unemployment and controlling growing expenditures on social welfare grants.

INTRODUCTION

¶2. (U) Every October, the Finance Minister presents the Mid Term Expenditure Framework (MTEF) to Parliament which details updated budgetary plans for the next three fiscal years. On October 26, Trevor Manuel summarized proposed policy changes and updated economic, expenditure and revenue estimates in his Mid Term Budget Policy Statement (MTBPS), which outlines the government's MTEF. The MTBPS provides an opportunity for a mid-year adjustment for policies that would support key government priorities and forecasts that determine how well macroeconomic targets are met.

MACROECONOMIC FUNDAMENTALS ON TRACK

¶3. (U) The National Treasury revised GDP growth forecasts upward. It now expects growth to be 3.9, 3.7, and 4.2 percent for 2005, 2006, and 2007 respectively, compared to 2.9 percent expected for ¶2004. (Note: Growth forecasts are given for calendar years instead of fiscal years. Endnote.) The Treasury expects the targeted inflation rate (i.e., consumer prices excluding mortgage costs) to remain within the 3-6 percent range throughout the MTEF period at roughly 5 percent, slightly higher than expected for 2004. In 2004, the current account deficit should widen, reaching 2.2 percent of GDP as compared to 0.8 percent in 2003, but be easily financed from capital inflows. The current account deficit rises over the MTEF period gradually, reaching 2.8 percent in 2007. The country's balance of payments position is strong, allowing the South African Reserve Bank to steadily increase foreign reserves.

¶4. (U) Domestic investment has grown over the past two years, with real fixed capital formation increasing by 6.1 and 8.4 percent compared with real GDP growth of 3.6 and 1.9 in 2002 and 2003. However, the government wants to dramatically increase gross fixed capital formation over the next three years to grow the economy at 6 percent, the figure believed to be necessary to make real progress in reducing the country's very high unemployment. Gross fixed capital formation currently is 16 percent of GDP. The government's goal is increase this to 25 percent of GDP by 2014. Low inflation and interest rates should help this effort, as should the government's

intention to undertake a massive spending program to invest in the country's infrastructure through public-private partnerships.

REVENUE OUTLOOK STRONG

¶5. (U) For FY2004, tax revenue is expected to be R1.9 billion higher than estimated last February, largely because of higher than expected collections in value added and personal tax revenues. Corporate taxes should be R6.2 billion less than budgeted, as the strong rand has hurt corporate profits. In FY2004, revenues as a percent of GDP should be 24.5 percent, rising to 25.1 percent by FY2007. Over the next two fiscal years, revenues are expected to increase by 10 percent and expenditures by 9 percent, which should cause the deficit gradually to improve. According to the National Treasury, the budget deficit as a percentage of GDP should be 3.2 percent in FY2004, 3.5 percent in FY2005, 3.2 percent in FY2006, and 2.7 percent by FY2007. Manuel announced no new tax policies, but did tag the mining sector for a full review.

EXTRA SPENDING NEEDED THIS YEAR

¶6. (U) The government will spend an extra R50 billion ($8 billion) on poverty alleviation, infrastructure improvements, and increased wages of teachers and police. Out of the R50 billion, 20.8 ($3.4) billion will go to cover growing expenditures related to social welfare grants, especially in the categories of child support and disability. Two million people joined the list of grant beneficiaries between April and September alone, pushing the total number of beneficiaries to nine million - or one out of every five South Africans. Currently, the provinces administer three types of grants are given: (1) child grants (also including foster care) for children up to 10 (this will be extended to children aged 13 in 2005); (2) disability grants (here, definitions have been unclear and this is a source of concern); and (3) grants for the elderly.

¶7. (U) Beginning in March 2006, a new national welfare grant agency will take over the administration of welfare funds from provincial government. In the meantime, welfare funds will be sourced from conditional grants (grants paid by the national government to provinces for prescribed purposes) rather than from the equitable share of revenue that the provinces get from the national government. The change means that overruns will now be the responsibility of the national government, even though the provinces will continue to distribute the grants until the changeover in 2006. Under the current system, the provinces must fulfill their obligations for paying out social welfare grants over other forms of provincial expenditure. In some cases, this has meant that the provinces have had to cut back on critical health and education expenditures, or taken bank overdrafts, to pay out growing numbers of social welfare grants.

FOREIGN EXCHANGE CONTROLS RELAXED

¶8. (U) Minister Manuel also recommended that certain foreign exchange controls be relaxed. Current rules limit direct foreign investment by South African corporations to R2 billion per project in Africa and R1 billion elsewhere, plus 20 percent of any excess cost. Manuel removed these limits and lifted restrictions on the repatriation of foreign dividends. However, corporations will still be required to apply for South African Reserve Bank approval (one of the stipulations being that the investment must be in the interest of South Africa). To facilitate his move to allow secondary foreign listings on the South African exchanges, Manuel will also allow South Africans to invest in such shares. Limits on other foreign investments by South African pension funds, insurance companies, mutual funds (unit trusts), and individuals remain in place, but could be removed in future.

COMMENT

¶9. (SBU) The state of the economy outlined by the National Treasury in its MTBPS is fairly strong. The National Treasury fully expects inflation to stay on target in the near term. It believes that falling interest rates will encourage more investment and

that this should lead to an average economic growth of 4 percent over the next three years. As revenues increase and social grant payments are brought under control, the National Treasury expects the fiscal deficit to increase to 3.5 percent next year, but then decline. The healthy state of the South African economy has led several international credit agencies to revise or review their credit ratings. One question mark on the horizon is whether strong global economic growth stays on track and whether the rand will grow even stronger. Another question mark is what would happen if growth in Europe (South Africa's major trading partner), and China (which is fueling world demand for commodities) slows, as this would have unfavorable consequences on South Africa's manufacturing and minerals exports, and thus growth. Finally, the government knows that the increase in social welfare grant payments is not sustainable over the long term and it needs to get control of the situation. Right now, the trend line shows these expenditures rising from 16.9 percent of all government expenditures in FY2003 to 20 percent in FY2007. The government wants to reverse this trend in social welfare grants by growing the economy faster and putting people to work. While the government's forecasted growth of 4 percent growth over the MTEF is a solid improvement over the last three year period, it is still less than what the government thinks it needs to make a significant dent in unemployment, i.e., GDP growth on the order of 6 percent.

FRAZER